June 21, 2004

ACTION MEMORANDUM

TO: Lisa Fiely, Chief Financial Officer

FROM: David Ostermeyer, Chairman of the Credit Review Board

SUBJECT: CRB Recommendation for Approval of Development Credit Authority Activity in Romania

As described in the attached documents, USAID/Romania intends to sign a loan guarantee agreement with Volksbank in Romania in support of the Mission's Strategic Objective 1.3. Accelerated private sector growth by supporting a market-driven environment, 1.3.1. Improved policy/legal/regulatory framework supportive of market expansion, Activity 4 of PRIDE: Privatization, Investment, and development of Energy Program —*Investment and Credit: Increase efficiency of energy use and reduce pollution per unit of GDP by implementing private energy efficiency projects.*

The Credit Review Board has reviewed this transaction and found that the risk has been appropriately assessed and that there is reasonable assurance of repayment of the obligations covered by these guarantees. Furthermore, the CRB has approved the subsidy cost to be associated with this activity and believes the Office of Development Credit has adequately provisioned for the risk entailed in this prospective agreement.

RECOMMENDATION

That the CFO sign below and thereby approve the findings of the Credit Review Board and the recommendation of the Chairman of the Credit Review Board with regard to this activity.

Approval:

__________________ ________
Lisa Fiely Date
CFO

Mission Approval:

________ __________________
Date
Mission Director

Attachments:

I.	Project Information Sheet	IV.	Financial Viability Analysis	VII.	Risk Assessment
II.	Activity Description	V.	Fee Justification	VIII.	Subsidy Cost Calculation
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cc: CRB Members

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Attachment I: Project Information Sheet – Volksbank Romania

Project Identifier:	Loan Portfolio Guarantee for Municipal Credit

Country	Romania	Mission/Bureau	USAID/Romania
Mission/Bureau Program Officer	Virgil Musatescu, USAID/Romania	Fin. Viability Analyst	Reid Click
ODC Relationship Officer	Sandra Goshgarian, EGAT/DC	Credit Analyst	
	Concur:	Chief Risk Officer	Kathleen Wu, EGAT/DC

Type	Loan Portfolio Guarantee	Guarantee Number	
Lender(s) /Guaranteed Party	Volksbank Romania		

Borrower(s)	Municipalities, Municipal Enterprises, and Engineering Service Companies (ESCOs) and Equipment Vendors providing service to the public sector in the areas of energy efficiency, water supply and wastewater treatment.

Mission SO(s) Supported by Activity

The PRIDE program (Privatization, Investment, and development of Energy Program) addresses the following activities under SO 1.3

(1) ***Privatization**: Support the transfer of the energy sector's public assets to private ownership* by providing technical assistance to help national and local authorities introduce appropriate privatization instruments and transparent procedures.

(1) ***Legal and Regulatory Reform:** Reform the legal and regulatory environment* for electricity and gas companies by adapting legislation to the new market conditions, especially in the fields of regulation and competition;

(2) ***Competition and Competitiveness:** Improve utilities' competitiveness, and increase competition* by restructuring power and gas generation and distribution companies;

(3) ***Investment and Credit:** Increase efficiency of energy use and reduce pollution per unit of GDP* by implementing private energy efficiency projects.

The proposed program most closely meets activity 4.

Sector

Energy Efficiency, Water Supply and Wastewater Treatment Sectors

Activity Description

In order to increase municipalities and other public sector entities access to credit for infrastructure improvement in Romania, a portfolio guarantee will be issued to a private commercial banks that will make loans to the municipalities or companies that service the municipalities to finance efficiency and capital improvements on municipal infrastructure such as water supply, wastewater and solid waste disposal and treatment, rehabilitation of district heating and cogeneration systems, multi-family residential energy efficiency programs, street lighting, and equipping schools and hospitals with efficient energy saving devices. All these measures will also have significant beneficial environmental impact in reducing air and water pollution.

Performance Indicators	Quantifiable Measures of Benefits • Annually review and determine number of loans and the amount of loans disbursed by Volkbank for the energy efficiency and municipal water supply sectors utilizing the DCA Instrument. • Effective 2006, on an annual basis, review the energy savings realized related to financing or cofinancing of the DCA instrument with potential partners such as UNDP, FREE, RAEF, and APER. Other Benefits • Reduced energy use for increased volume of power and district heat consumption by population • Reliable water and district heat supply services at affordable prices

	• Cost savings in delivery of a broad range of municipal services by service providers • Reduced bills and control on rising utility costs for end-users • Improved collection rates for delivery of municipal services and enhanced performance and financial efficiency of municipal service providers • Mitigation of adverse environmental impacts • Availability of financing for upgrading utility systems that will enhance health and safety of the population and delivery of increased volume of communal services. • Reduced reliance on imported fuel and improved the country's trade balance

Max. Cum. Disbursements ($)	5,000,000	Guarantee currency	ROL and Euro
Term *(years)*	5 years	Type of Risk sharing	Pari passu
Interest Rate (%)	Market	Guarantee percentage	50%
Revolving?	No	Guarantee ceiling ($)	2,500,000
Initial Disbursement *(year)*	FY 2005	Payment guaranteed	Principal only

Notes on Transaction Terms	

Commitment Fee ($)	0.375%				
Utilization Fee (%) p.a.	0.50%	Util. fee payment Basis	Fee paid in 4 annual installments	NPV ($)	

For Loan Portfolio Guarantees (LPGs)	
Est. number of sub loans	5-10
Est. avg., sub-loan maturity (years)	3
Est. avg. size of sub-loans ($)	100,000-500,000
Max. auth. Portfolio Amount ($)	1,000,000

For Bond Guarantees	
Type	
Coupon (%)	
Trustee	
Investors	
Secondary Investors	

Subsidy Cost	$	%	**Net Defaults**		Fees		Nom. Defaults	

Funding Source/FY	

WARF Score			
Country (%)		Borrower **(%)**	
Lender (%)		**Transaction** (%)	

Key Risk Factors: Brief list of key factors (e.g., nature of the lending activity, specific management concerns, sectoral concerns, etc.)

Special conditions for approval:

Attachment II: Activity Description

1.0 Background

Municipal infrastructure in Romania faces critical investment needs that are not currently being met. Poor performance, exacerbated by a lack of maintenance and investment by municipal district heating and water/waste water systems has resulted in deteriorating service and increasing tariffs, making the service unaffordable to many customers. In response, many customers respond by not paying for the inadequate service which further erodes the system revenues and the opportunity to make the necessary investments.

Recently, in the absence of a well-defined regulatory environment many consumers have already been effectively disconnected from the district heat networks, jeopardizing the commercial ability of the systems to continue its operations. Non-payment of water/waste water bills similarly removes the revenue needed to maintain and run the system, and makes the water systems among the largest non-payers of electricity bills, which represents one of the most significant expenses. Clearly, there is need for investments among the district heat and water/wastewater networks, and among end-use customers, to help them control the rising costs. According to data from Romania's Court of Accounts, rehabilitation of the district heating system requires an injection of 4 billion euro investments between now and 2015 at a rate of 325 million euro per year. The estimated investment required to meet the EU's urban water standards approximates 20 billion euro. In addition, the annual disposable income of energy end-users is significantly reduced by the inefficient use of energy.

Given the seriousness of the problems, it is necessary to address solutions through improved efficiency investments among both the service providers and end-users. First, improving the delivery and reliability of district heating and water treatment systems will increase the likelihood that customers will pay for a service with a resultant stabilized tariff structure. Secondly, improving the end-use efficiency of other municipal facilities such as schools and hospitals will also help customers to control rising energy and water costs. The efficiency investments can pay for themselves through these savings and reduced costs will help to provide additional services from limited municipal budget revenues.

Most municipalities have traditionally relied on subsidies and transfer of funds from the central bank to sustain basic municipal operations. To date there has been little interaction between municipalities and private banks to acquire commercial loans. The municipalities are legally constrained on their borrowing limits and to compound the situation Romanian commercial banks are conservative and on a case-by-case basis provide only a few loans to a handful of creditworthy municipalities.

USAID is well positioned to provide a solution through the Development Credit Authority (DCA) that will provide partial (50%) guarantees on commercial bank loans. USAID/Romania has identified Volksbank which is interested in expanding its services to the municipal sector. The proposed DCA guarantee would secure up to 50 percent of the portfolio principal of up to $5 million in Volkbank loans to municipal governments for energy and water/waste water efficiency improvement and the rehabilitation of networks and equipment.

2.0 Developmental Importance

Continued *energy sector* strengthening is critical for Romania's economic growth and EU accession. A strong energy sector, with a contribution to GDP of around 15%, will support the country's economic and political stability. At the same time, financial and operational strengthening of the sector will boost foreign trade, including American trade and investment opportunities.

Energy efficiency is one of the most important issues for consumers. In Romania the amount of energy used to produce a unit of domestic product is several times that in many developed countries. This raises prices for industrial products and reduces Romania's competitiveness. Inefficient energy generation and losses during distribution increase domestic energy bills for all households. Romania's dependence on two main sources of imported energy - oil from the international market, especially the Middle East, and gas from Russia – is increased by the inefficient use of energy. This elevates energy supply risk and increases Romania's trade deficit.

Similarly, *water* is an essential economic commodity and its current mismanagement has an enormous adverse impact on urban development. Satisfying the needs of the public and industry and protecting water resources against depletion and pollution requires the commitment and work of all stakeholders. In Romania, urban water resources are limited and their quality is reduced by urban pollution. Drinking water quality and availability throughout the country is poor, leading to higher morbidity and other hardships. Improving the municipal water situation would have a positive impact on all sectors of the economy, relations with neighboring countries, and the overall image of the country.

Investment in urban water infrastructure in Romania has been slower than in most transition countries in the region. Despite more rapid progress being made over the past five years, additional investments of billions of dollars will be needed to bring urban development to the standards required for EU membership. It is in USAID/Romania's interest to continue as a respected leader in providing such assistance in the Romanian urban water sector.

Commercial lending is essential for efficiency improvements and the rehabilitation of municipal infrastructure. Northern tier countries such as Poland, the Czech Republic, Hungary and Slovakia have all developed blossoming municipal credit markets through bond issuance and banking relations after overcoming legislative constraints and an initial reluctance on the part of both municipal governments and financial institutions. In these transition countries, medium and long-term credit instruments are now an accepted and a common part of municipal development strategies. Romania has begun to follow this same path.

Foreign-owned banks, which have extensive experience making loans to municipal governments elsewhere in the region, are looking for initial openings in Romania to build this activity. Some municipalities are increasingly becoming more professional in the areas of financial management and planning practices and entrepreneurial in terms of creative searching for new financing sources and the fostering public-private partnerships. USAID local government technical assistance programs in Romania being implemented by DAI through the GRASP Program are working to build local government management capacities. Commercial banks are interested in building municipal credit markets in Romania, but as this is a relatively new undertaking, the reduction through DCA of the high-perceived risk of municipal lending is highly desirable.

3.0 Activity Description

The purpose of this activity is to facilitate the increase of municipal access for bank financing of energy efficiency, water and waste improvement programs in Romania. A portfolio guarantee will be offered to one or more private commercial banks that are willing to expand lending activities to the municipal sector in these target areas. The bank will make loans to the municipalities, municipal enterprises, or engineering service companies (ESCOs) to finance efficiency and capital improvements on a variety of infrastructure projects including water supply, wastewater disposal, district heating systems, cogeneration systems, energy consumption by residential multi-family homes, schools, and hospitals, etc. This program or facility allows the U.S. government to issue a guarantee on 50% of the amount of loans. This guarantee covers the secured loan principal amount only within the duration of this activity.

The total estimated amount of the loan portfolio for this activity is $5 million. Any municipality, municipal agency or a private service company that meets the criteria for a qualifying borrower can apply for a loan with the participating bank. The participating bank(s) will utilize their own discretion in approving loan applications from qualifying public sector entities. Individual municipalities are allowed single or multiple loans under this program. Loans can be utilized to rehabilitate existing equipment or to replace with more energy efficient equipment such as pumps and motors for water and wastewater treatment plants, for new sub-stations, replacement of energy inefficient boilers, and the installation of energy efficient insulating material in multi-family homes to significantly reduce heat losses from steam and hot water piping networks.

USAID/Romania’s experience shows that there are a number of creditworthy municipalities and there are also a number of municipalities that are on the borderline of satisfactory commercial viability. All such municipalities or cities could benefit from this program, perhaps by taking out loans, establishing a good credit history with the participating commercial bank, and then maintaining a good track record for the future. A good track record is important, as the whole commercial lending operation is evolutionary in Romania. Thus, the DCA facility is timely.

Most lending by Romanian banks is done on a case-by-case basis for a limited number of creditworthy municipal agencies, mainly for road construction and housing rehabilitation. Existing lending by commercial banks is based on an established mutual trust between the bank’s management and municipal officials. Romanian banks do not have the necessary skilled personnel to evaluate the technical merits of many municipal projects. Municipalities on their part also lack the skills needed to properly define and promote to banks the technical and commercial merits of projects for purposes of obtaining loans.

In the given Romanian environment the loan guarantee offered by the DCA may serve as a substitute for the lack (or a weakness) of collateral in commercial bank/municipality credit operations and that may lower the perceived credit risk for commercial banks. Therefore, the

DCA facility could contribute to a significant increase in the number of municipal projects qualified for commercial lending.

The total estimated amount of loans to be issued under the project is $5 million. During the preparation of this document the PRIDE team reviewed a host of municipal projects. The value of these projects ranges between $5,000 to several million dollars. Smaller loans below the amount of $100,000 may not attract the banks' attention, due to the high costs associated with the preparation of documents and servicing of the loan. However, it may be possible to package a few smaller loans as a bundle to increase the investment value to $100,000. We envision that a typical loan size for a DCA-backed loan in Romania may be in the $100,000 to $500,000 range.

4.0 USAID/Romania Goals

The proposed project directly supports the following USAID/Romania strategic objective, as set out in the "USAID/Romania Country Strategic Plan for FY 2004 for PRIDE Activity 4: ***Investment and Credit:* Increase efficiency of energy use and reduce pollution per unit of GDP by implementing private energy efficiency projects.**

Increasing the public sector's access to finance is the most critical requirement for improving municipal services in Romania. As the municipalities and cities develop the practice of receiving loans from banks and establishing a credit history, they will be less dependent on central bank and donor funding for much needed energy efficiency and water related projects. The municipalities must adhere to a host of institutional and legal requirements for loans and debts. For example, the level of debt service cannot exceed 20% of a municipality's own revenues, as defined by its tax base and local revenue streams.

A recent study completed by DAI under the Governance Reform and Sustainable Partnerships (GRASP) Program delineates the extent of public debt. Local public debt in Romania amounts to about EURO 8.7 billion as of the end of June 2003. Over the 1999-2000 period, local public debt grew from 35% to 38% of total public debt and represents about 11% of GDP. The study concludes that domestic local public debt - contracted directly by the LGUs - represents less than 1% of total local public debt. Domestic debt is mainly short and medium-term.

External debt is contracted with international financial institutions such as the European Bank for Reconstruction and Development, European Investment Bank and World Bank (IBRD/IFC). External debt is contracted and/or guaranteed by the central government and the LGUs; it is long-term and hard currency denominated.

The DAI study concludes that domestic local public debt is in the form of bank loans and municipal bonds. The main lenders to LGUs are BRD-Societe Generale, Commercial Bank of Romania (BCR), BancPost, Banca Transilvania and more recently, Raiffeisen and Volksbank. Bank loans are both lei and hard currency denominated. Most of them are short-term and more recently medium-term. Interest rates are similar to those offered by the lenders to private entities. A very small percentage of public sector loans portfolio have not made timely payments or have defaulted.

The first municipal bonds were issued in October 2001. The two issues of 2001 amounted to 7% of the domestic debt of that year. In 2002 there were eight bond issues. The DAI report concludes that the municipal bond market has registered very positive trends and about US$ 3.0 million has been raised so far. Out of the nineteen issues, nine are currently listed on Bucharest Stock Exchange. Typically, the issues are relatively small in size and, as such, are not very attractive to investors. The interest rates have ranged between the commercial loan and the T-bill rates. Issuers are mostly large cities, but also some small cities with good commercial, industrial or tourist economic potential.

The expected development impact of the proposed DCA facility can be summarized as follows:

- Increased access by the municipal sector to commercial financing for energy-efficient capital investments;
- Private sector credit more available to municipalities: municipalities are expected to be more willing and able to borrow from banks, and banks are more willing and able to lend to municipalities;
- Decreased rate of growth in energy consumption and increased energy efficiency in water/wastewater and district heating systems of participating borrowers;
- Reduced unit operating costs at participating borrowers, contributing to improved financial performance and reliability of supplies at affordable prices;
- Greater financial autonomy of the municipalities; and
- Greater financial sustainability of the local governments.

Attachment III: Economic Justification

1.0 Introduction

This Economic Viability Analysis evaluates the extent to which the proposed municipal credit DCA is necessary for increasing access of Romanian municipalities to commercial bank credit. The document describes the existing trends in the municipal credit market, assesses the potential for improved public sector access to commercial bank loans and evaluates the impact of the proposed DCA intervention.

2.0 DCA will Address Imperfections in the Municipal Market

Municipalities and relatively larger cities in Romania are in need of access to credit in order to invest in their heating, electricity generation and supply, and drinking water systems and to ensure service sustainability over the medium and long term. Most of the utility systems in the country were built in the 1960s and 1970s. As a result of minimal capital investment and poor maintenance over the past 30 years, the overall condition of the individual systems is poor, water and heat losses are high, energy consumption is disproportionably high, and the overall environmental conditions are poor.

In order to comply with European Union standards for municipal service delivery, it is estimated that Romania will need to undertake significant investments in order to be able to fully implement the EU environmental legislation and meet the EU environmental standards. Instrument for Structural Policies for Pre-Accession (ISPA) funding will concentrate on the most "investment heavy" environmental directives, i.e. directives that are very costly to implement in the following areas: drinking water supply, treatment of waste water, management of solid waste and hazardous waste, air pollution. The implementation of these directives is closely related to the improvement of the health and quality of life of citizens and has a direct positive impact on the economic and social cohesion of the beneficiary countries. Romania is the second largest recipient of the ISPA loan after Poland with 240 million Euro per year, roughly divided between transport and environment projects.

Projects submitted for approval under ISPA must have a minimum budget of 5.0 million Euros, out of which a maximum of 75% of public expenditure can be covered by ISPA funds. The rest is to be provided by the beneficiary from central or local budgets, commercial loans, or grants from donors. The minimum 25% of co-financing from the beneficiary is a pre-requisite for any ISPA project in order to be accepted by the Management Committee, in parallel with the preparation of the applications. Thus, in order to qualify for the ISPA favorable financing, many municipalities would have to apply for commercial loans to secure their co-financing requirements. Therefore, the DCA facility through expansion of commercial lending opportunities for municipalities will facilitate the effective and timely implementation of the multi-million ISPA infrastructure improvement programs which are of a great importance not only to Romania, but to all Southeast Europe countries.

There are also other donors programs, such as Swiss Government aid and the FREE project, offering favorable lending/financing terms to municipalities for satisfying their investment needs. There is also a co-financing requirement (e.g. in the Swiss Government program) or a ceiling for individual loans. In FREE's case the ceiling is $1.0 million. In both cases, DCA–backed commercial loans can be used to secure the municipalities' own contribution or provide the balance of needed resources. It should be stressed that such co-financing schemes with the participation of DCA loans not only leverages additional resources but also result in more attractive lending terms overall for municipalities than outright financing of the project by DCA loans.

Commercial bank lending to the public sector to date, including municipalities and cities, has been rather limited. Very few municipalities may have lines of credit that allow them to access small amounts of credit for short periods of time, usually to cover operational costs, e.g., payments to the electrical power company or the gas company. Most of these lines of credit require payment within six months or, at most, one year. Such a short lending term makes it impossible to finance medium-sized or large capital investment projects, since the concentration of all payments within one year would cause a significant spike in the tariff, often making it unaffordable to customers.

With the ongoing transfer of non-profitable central government assets, such as district heating systems, to local governments, most municipalities have operated at a loss and continue to do so. Also, municipalities are restricted in utilizing collateral for loan guarantees. They cannot use certain types of fixed assets as collateral for bank loans. This situation increases the bank's perception of the high risks associated with lending in the communal services sector.

The actual risks associated with lending to municipalities are decreasing, but the perception of risk on the part of banks remains essentially unchanged. The proposed DCA mechanism would respond to this market imperfection by lowering the banks' perceived risks through the provision of a partial guarantee.

3.0 Additionally of the DCA Guarantee

There is still a high level of uncertainty about the political commitment to meet debt obligations by newly elected municipal officials. In some cases municipalities could provide certain municipal assets as collateral. However, not all assets administered by municipalities can be used as collateral and the sale of municipal owned assets may not bring in the anticipated revenue. Therefore, the DCA guarantee could be used by commercial banks as a collateral substitute allowing commercial banks to extend their area of lending to additional creditworthy municipalities, municipal enterprises and/or service-providers to municipalities.

4.0 DCA Will not Supersede Private-Sector Financing

As noted in the previous section, private commercial bank financing exists today only at very low volumes in the municipal sector. Some vendor financing is available by large European equipment manufacturers, but it does not allow for flexibility in the choice of equipment. Energy Service Company (ESCO) financing is very limited or non-existent for municipalities. There are no private domestic or international water/wastewater or district heating service companies that are actively investing in Romanian municipalities. Essentially, there is little private financing in the sector and therefore little financing to supersede.
On the contrary, the proposed municipal DCA has the potential to be on the cutting edge of commercial bank financing to the Romanian Public Sector. The DCA guarantee would essentially function as a

catalyst. While banks are currently not inclined or willing to lend to municipalities, the provision of a US-Government guarantee for 50% of the loan amount will serve to lower the banks' perception of risk, thereby encouraging them to make a loan. If the municipalities successfully repay the loans, then banks will, most likely, be willing to lend to them again in the future without a DCA guarantee. The value of the DCA is in the demonstration effect. A DCA-backed loan can demonstrate to commercial banks that lending to municipalities can be profitable, thereby sparking interest in further investment in this sector.

5.0 USAID Is Guarantor of Last Resort

There are no credible alternatives to DCA as a guarantee of bank loans to the public sector. No donors provide loan guarantees to this sector. USAID is therefore the guarantor of last resort with respect to commercial bank loans to the public sector. The DCA activity would neither impede nor replace any other international lending activity, but it may support or enhance implementation of many important international assistance and development programs financed by the EU, Phare, ISPA, WB, EBRD, EIB and others.

6.0 Coordination with other projects to facilitate implementation and broad use of the DCA Guarantee

There are a few well-advanced technical assistance projects that could contribute greatly toward a successful start and effective operation of the DCA facility in Romania. We determined that there are several international donor organizations such as UNDP, The Romanian Energy Efficiency Fund (FREE), and The Romanian Investment Energy Efficiency Company (RIECC), actively promoting and funding energy efficiency projects in Romania. These organizations have certain funding restrictions, but are open to co-financing opportunities to increase the loan amounts. These organizations have in-house capability and technical staff that could initially be a potential resource to a commercial bank to provide technical evaluations.

Initially, such technical staff could assist the commercial banks with project descriptions in a format acceptable by a bank. Later on, the coordination effort could focus on the screening and review of bankable project information and monitoring bank activities with the use of the DCA facility.

7.0 Conclusions

This analysis indicates that the municipal market suffers from imperfections. While demand for credit on the part of municipalities is growing and the creditworthiness of these potential borrowers is increasing, commercial banks remain for the most part unwilling to make medium or long-term loans to many municipalities. This low level of activity is primarily due the banks' perceived high risk of lending to municipalities. However, as a market economy takes hold, risks will decrease over time, and banks could make increasingly successful and profitable loans.

DCA is in a position to be a catalyst to commercial bank lending to municipalities by providing a partial guarantee, thereby lowering the banks' perceived risk. No other private financing would be displaced by this activity. USAID is the guarantor of last resort.

Attachment IV: Financial Viability Analysis

Purpose of Analysis

The purpose of this financial viability analysis is to demonstrate the proposed guarantee facility's financial viability from the perspective of the lender, Volksbank Romania, and also from the perspective of indicative borrowers under the facility. This is to insure that the facility represents an attractive instrument for prospective borrowers and that investment made with guaranteed funds will generate sufficient cash flows to repay the underlying loans. The analysis is divided into two sections: Activity Viability for the Lender and Activity Viability for the Borrowers. Borrowers are defined as municipalities, municipal enterprises and ESCOs operating in Romania.

Volksbank will have full authority to approve or reject loan applications from the above-mentioned borrowers. The DCA guarantee acts as an incentive to Volksbank to lend to municipalities, municipal enterprises and ESCOs for energy efficiency and water-related projects. Volksbank has indicated that, as a result of the guarantee, it may be willing to offer municipalities longer loan terms and lower interest rates. These relatively attractive conditions will encourage borrowers to apply for loans to incorporate new energy efficiency measures by rehabilitating their deteriorated physical assets.

1.0 Activity Viability for the Lender

Banking Sector Profile

Like many other countries in Central and Eastern Europe, restructuring of Romania's banking sector over the last decade has had its share of difficulties. Poor regulatory and supervisory standards, property rights issues and staffing constraints have led to a significant under capitalization of banks in Romania, characterized by significant non-performing loan portfolios and poor market discipline. The ensuing banking crises dragged on for years, resulting in numerous bank failures. Developments during the past few years are encouraging, however, and Romania hopes that current economic stabilization will be accompanied by faster consolidation in the banking market.

As at the end of 2002, the Romanian banking sector comprised 31 banks, plus 9 branches of foreign banks. There are currently 46 registered banks, of which 35 are active. The market leader is Banca Comerciala Romana (BCR), with a market share of 29.4%, followed by the Romanian Development Bank, Raiffeisen and the State Savings Bank (CEC), at 13.3%, 7.2% and 6.5% market shares respectively.[1] At the end of 2002, the five largest banks had a 63% market share, and the top 10 banks just under 83% - a relatively high level of concentration. The importance of foreign banks has increased significantly in recent years. France's Societe Generale acquired 51% of the Romanian Development Bank in 1999, GE Capital and BPI jointly acquired 45% of BancPost also in 1999, and Banca Agricola was sold to Raiffeisen Zentralbank in 2001. The privatization of BCR will further strengthen the foreign banks' market position – with 25% of the shares recently sold to the EBRD and the IFC with a goal of attracting a 51% strategic investor by 2006. CEC and Exim Bank remain publicly owned.

[1] Die Bank

Since January 2000, ROL denominated credits, as well as Euro denominated credits, more than doubled. From April 2003 to April 2004, non-governmental credit increased by 62% in nominal terms and 44% in real terms. Until 2002, banks focused on corporate credit but mortgage and retail credit are now growing exponentially. The soundness of the banking sector has improved significantly since the 2001 clean-up and the performance indicators for most banks have reached internationally accepted benchmarks. The latest regulatory amendments have prohibited privileged access of public institutions to the resources of financial institutions, including the Central Bank, thereby improving further access to credit by the private sector and individuals.

Volksbank Romania

Volksbank Romania, a subsidiary of Osterreichische Volksbanken AG (OVAG), has operated in Romania since May 2000. OVAG is a major player in the Central and South Eastern Europe banking markets, having 74 branches in 11 countries with 1,400 employees servicing over 400,000 accounts. OVAG was founded in Austria in 1922 and today is an international commercial bank and a strong partner in Central and Eastern Europe, with assets in the region in excess of €2.3 billion. OVAG owns 99.96% of Volksbank Romania. The following table illustrates OVAG's Moody's Investors Service ratings:

	2002	**2003**
Long-term	A-2	A-2
Short-term	P-1	P-1
Capital Adequacy (%)	12.70	11.67

Volksbank Romania strategically focuses on small and medium enterprises (SMEs), microenterprises and individuals. In 2003, 74% of loans were to corporations in the services industry, 13.5% to individuals and 8% to trading enterprises. The European Bank for Reconstruction and Development (EBRD) has provided a €12 million facility to Volksbank Romania to facilitate the access to finance of small and medium-sized enterprises and to promote SME growth and development. Volksbank is unique in Romania in that it offers customized loans for high capacity heating system acquisition by block homeowners' associations, which ties in closely with the objectives of this DCA guarantee facility.

Volksbank Romania has grown significantly since its establishment in 2000 and currently operates through 14 branches, serving its target customers: SMEs, microenterprises and individuals. Volksbank Romania currently has approximately 5,000 corporate clients and 30,000 individual clients, which have increased 66% and 76%, respectively, from 2003 to 2004. Volksbank Romania currently employs approximately 203 staff.

The following table presents financial highlights for Volksbank Romania.

Volksbank Romania – Financial Highlights

Figures in $'000[1]	2002	2003	2004 March	2004 Budget
Loans Receivable	78,568	136,574	157,741	227,095
Loan provisions % of receivables	0%	<1%	<1%	<1%
Total Assets	120,228	185,239	198,894	281,244
Loans % of Assets	65%	74%	79%	81%
Total Deposits	106,320	168,446	181,891	261,316
Loans to Deposits	74%	81%	87%	87%
Total Liabilities	106,614	168,906	182,323	261,316
Capital & Reserves	13,615	16,333	16,571	19,928
Loans to Equity	5.8	8.4	9.5	11.4
Operating Income	3,988	7,068	2,755	10,019[2]
Net Income	(394)	723	506	1,839[2]

[1]Original figures have been converted at period-end exchange rates from € and ROL; percentages presented above are calculated based on source currencies.
[2] Calculated as annualized first quarter totals

The table above demonstrates the financial soundness of Volksbank Romania, although USAID should note some apparent deterioration against accepted benchmark ratios for financial institutions. Benchmark ratios[2] for loans as a percentage of assets, loans to deposits and loans to equity are 70%, 80% and 8% respectively. Volksbank Romania's ratios exceed these standard benchmarks, which may not be uncommon for new financial institutions experiencing significant growth, but may represent an issue to monitor closely or discuss further with Volksbank. Given that the proposed loan portfolio under the guarantee, of $5 million, represents only 5% of Volksbank Romania's total current loans outstanding, the risk to USAID from Volksbank's overall ratio management may not be significant.

Volksbank Romania ranks approximately 10th (based on total assets) among major banks in Romania, with a market share of approximately 1%. The total banking assets in Romania at the end of 2003 were approximately €14.634 million. Volksbank plans to expand at a rate of 3 – 4 new branches per year.

Cash flow projections and basis for assumptions

The cash flow projections and analysis presented in Figure 1 illustrate the financial viability of the proposed DCA guarantee facility from the perspective of Volksbank Romania.

Key Financial Measures

Net Present Value (NPV) of free net cash flows to the portfolio;
Internal Rate of Return (IRR) of net cash flows to the portfolio.

[2] Office of the Comptroller of Currency benchmark ratios

Key Assumptions

Terms of the DCA loan guarantee:

- The maximum volume of Volksbank loans to be covered by the USAID guarantee is USD 5 million or its Euro equivalent.
- The maximum credit loss to be covered by the USAID guarantee is USD 2.5 million or its Euro equivalent (based on a 50% guarantee.)
- The DCA project lasts seven years.
- Maximum cumulative loan to one borrower is USD 1.0 million.

Interest rates:

- Interest rates on ROL denominated loans under the DCA guarantee based on BUBOR (the Romanian Central Bank's refinancing rate) plus 5%; BUBOR is predicted to decline from 20% to 12% by year 2011.
- Interest rates on Euro denominated loans assumed to decline from today's 14% level to approximately 8.5% by the year 2011, with an average of 11% over the period 2005 to 2011.

Discount rate:

- The ROL discount rate is assumed to be the required rate of return for the bank's assets on a WACC (weighed average cost of capital) basis. The bank's WACC is 6.04% based on an average 8.6% cost of debt and a 15% cost of equity. The analysis assumes a stable WACC over the period 2005 – 2011.
- The Euro discount rate is based on a WACC of 3.64% based on quarterly Euro LIBOR of 2.09% plus 1.25% fund insurance – approximately 3.5%. With the expanding economies in the Euro zone, LIBOR may reach 4%. As a proxy measure, the analysis assumed an average 3.64% WACC indicator.

General & Administrative Costs:

- Average G&A to loan portfolio rate of 2% based on Volksbank Romania's prior experience.

Anticipated default rate:

- The anticipated default rate is assumed at .222% consistent with Volksbank Romania's historical experience.

DCA origination and utilization fees:

- Origination fee of 0.375% on the guaranteed portion of USD 2.5 million, payable in four equal installments within 12 months from the day of signing the DCA agreement.
- Utilization fee of 0.50% per annum, payable semi-annually.

▪ These fees are assumptions based on current discussions between Volksbank Romania and USAID – final fees have not yet been concluded.

Loan Amount and Anticipated Implementation Schedule:

▪ The USD 5 million loan portfolio is assumed to support seven or more individual loans, in the €300,000 to €500,000 range. The disbursements are assumed to occur over the period October 2004 to January 2006. Each loan has a five year maturity period, a six month grace period, with semi-annual principal repayments in equal installments.

Profitability Analysis

Using the above assumptions, the analysis presented at Figure 1 calculates the NPV and IRR assuming both a Euro and a ROL denominated portfolio. The NPV was positive €323,111 under a Euro portfolio and the Euro equivalent of €345,569 for a ROL portfolio. In both cases, IRR is above the cost of capital, at 7.2% vs. 3.64% in the Euro scenario and 10% vs. 6.04% in the ROL scenario. These figures assume only one cycle of loans – re-lending principal payments received will increase the profitability measures.

Sensitivity Analysis

The following tables summarize the sensitivity of NPV and IRR to changes in the interest rate charged on the loans and in the discount rate used to value the portfolio.

Sensitivity of NPV and IRR in the Euro-denominated portfolio (Euro)

Interest rate:	**13%**	**11.15%**	**9.0%**	**8.5%**
NPV	538,346	323,111	72,915	14,730
IRR	9.7%	7.2%	4.4%	3.8%
Cost of Funds:	**2.0**	**3.64**	**5.0**	**5.4**
NPV	644,826	323,111	78,033	9,699
IRR	8.9%	7.2%	5.9%	5.5%

Sensitivity of NPV and IRR in the ROL-denominated portfolio (Euro)

Interest rate:	**23%**	**21.35%**	**19%**	**18.2%**
NPV	526,826	345,569	72,498	(523)
IRR	12.2%	10%	5.8%	n/a
Cost of Funds:	**5.0**	**6.04**	**7.5**	**8.0**
NPV	590,691	345,561	24,910	(79,001)
IRR	11.6%	10.0%	7.8%	n/a

The above tables demonstrate the tolerance of the portfolio's profitability to changes in key variables, all others remaining constant. The portfolio has a 3% tolerance to downward changes in interest rates, although since a change in interest rates would also likely reduce the cost of capital, the actual tolerance for interest rate changes would be higher than 3%.

The following Figures 1 and 2 present the computations of NPV and IRR for the base case scenario (highlighted above.)

Attachment IV: Financial Viability Analysis

FIGURE 1

Financial Viability Analysis for Volksbank Romania SA (Euro Portfolio)

Financial Viability Analysis								
Total Facility Amount	**€ 4,000,000.00**							
Coverage	**50%**							
Guaranteed Amount	**€2,000,000.00**							
Assumed Loan amount in US$	**€ 4,000,000.00**							
Guaranteed Amount for US$ Portfolio	**€ 2,000,000.00**							
Term in years	**5**							
Cost of Funds	**3.64%**	Apr						
Client Loan Rate	**11.15%**	Apr						
Commitment Fee	**0.375%**							
Utilization Fee	**0.500%**	*per annum*						
Cash Flows:	**1**	**2**	**3**	**4**	**5**	**6**	**7**	**Total**
Disbursements	€ (2,700,000)	€ (1,300,000)	€ -	€ -	€ -	€ -	€ -	€ (4,000,000)
Inflows:								
Principal Repayment	€ 100,000	€ 670,000	€ 800,000	€ 800,000	€ 800,000	€ 700,000	€ 130,000	€ 4,000,000
Interest Payment	€ 206,275	€ 419,798	€ 337,845	€ 248,645	€ 159,445	€ 70,245	€ 7,248	€ 1,449,500
USAID Coverage of Defaults	€ 340	€ 1,210	€ 1,263	€ 1,164	€ 1,065	€ 855	€ 152	€ 6,049
Disbursements less inflows	€ (2,393,385)	€ (208,993)	€ 1,139,108	€ 1,049,809	€ 960,510	€ 771,100	€ 137,400	€ 1,455,549
Outflows:								
Interest Expense	€ (47,288)	€ (124,766)	€ (95,666)	€ (66,566)	€ (37,466)	€ (10,185)	€ -	€ (381,938)
Overhead Expenses	€ (52,670)	€ (65,432)	€ (49,226)	€ (33,020)	€ (16,814)	€ (2,633)	€ -	€ (219,795)
Fees								
USAID Origin Fee paid in 4 installments	€ (7,500)							€ (7,500)
USAID Utilization Fee	€ (3,500)	€ (4,038)	€ (3,038)	€ (2,038)	€ (1,038)	€ (163)	€ -	€ (13,813)
TOTAL EXPENSES	€ (110,957)	€ (194,236)	€ (147,930)	€ (50,812)	€ (55,318)	€ (12,981)	€ -	€ (572,233)
Anticipated Defaults (b):	€ (680)	€ (2,419)	€ (2,526)	€ (2,328)	€ (2,130)	€ (1,710)	€ (305)	€ (12,098)
CASH FLOW	**€ (2,505,022)**	**€ (405,648)**	**€ 988,652**	**€ 996,669**	**€ 903,062**	**€ 756,409**	**€ 137,095**	**€ 871,218**

FIGURE 1		
Financial Viability Analysis for Volksbank Romania SA (Euro Portfolio)		
Discount Rate:	**3.64%**	(Weighted Average Cost of Capital)
NPV in Euro:	**€ 323,111**	
IRR rate	**7.2%**	
Assumptions:		
a) Assumed default rate:	0.222%	
b) Overhead expense	2.03%	
c) G&A rate of 2.03 is estimated from data presented in KPMG 2003 audit.		
b) Cost of funds is a projection estimated on the average cost for Euro.		
b) Client Loan Rate is an average from estimated rates for Euro loans for 2005-2011		

Attachment IV: Financial Viability Analysis
Office of Development Credit, U.S. Agency for International Development
Loan Portfolio Guarantee for Municipal Credit – USAID/Romania

Figure 2

Financial Viability Analysis for Volksbank Romania SA (ROL Portfolio)

Total Facility Amount	**€4,000,000.00**							
Coverage	**50%**							
Guaranteed Amount	**€2,000,000.00**							
Assumed Euro equivalent of Loans in Romanian Lei (ROL)	**€4,000,000.00**							
Assumed Loan Portfolio amount in 000s ROL	**163,172,000**							
Euro equivalent of Guaranteed Amount for ROL Portfolio	**€2,000,000.00**							
ROL equivalent of the Guaranteed Amount (000s ROL)	**81,586,000**							
Term in years	**5**							
Cost of Funds	**6.04%**	Apr						
Client Loan Rate	**21.35%**	Apr						
Origination Fee (Paid in 4 Installments in 12 month period)	**0.375%**							
Utilization Fee	**0.500%**	*per annum*						
Cash Flows (in 000s ROL) :	**1**	**2**	**3**	**4**	**5**	**6**	**7**	**Total**
Disbursements	-ROL 110,141,100	-ROL 53,030,900						-ROL 163,172,000
Inflows:								
Principal Repayment	ROL 4,079,300	ROL 27,331,310	ROL 32,634,400	ROL 32,634,400	ROL 32,634,400	ROL 28,555,100	ROL 5,303,090	ROL 163,172,000
Interest Payment	ROL 16,112,215	ROL 32,790,535	ROL 26,389,196	ROL 19,421,751	ROL 12,454,307	ROL 5,486,862	ROL 566,105	ROL 113,220,972
USAID Coverage of Defaults	ROL 22,413	ROL 66,735	ROL 65,516	ROL 57,782	ROL 50,048	ROL 37,787	ROL 6,515	ROL 306,796
Disbursements less inflows	-ROL 89,927,172	ROL 7,157,680	ROL 59,089,112	ROL 52,113,934	ROL 45,138,755	ROL 34,079,749	ROL 5,875,710	ROL 113,527,768
Outflows:								
Interest Expense	-ROL 5,174,184	-ROL 12,430,361	-ROL 9,473,685	-ROL 6,517,008	-ROL 3,560,331	-ROL 689,891		-ROL 37,845,461
Overhead Expenses	-ROL 2,148,555	-ROL 2,669,167	-ROL 2,008,073	-ROL 1,346,979	-ROL 685,885	-ROL 107,428		-ROL 8,966,087
USAID Commitment Fee Paid in 4 Installments	-ROL 305,948	ROL 0						-ROL 305,948

Attachment IV: Financial Viability Analysis
Office of Development Credit, U.S. Agency for International Development
Loan Portfolio Guarantee for Municipal Credit – USAID/Romania

Figure 2

Financial Viability Analysis for Volksbank Romania SA (ROL Portfolio)

USAID Utilization Fee	-ROL 4,526,277	-ROL 7,923,458	-ROL 6,034,495	-ROL 2,072,766	-ROL 2,256,568	-ROL 529,533		-ROL 23,343,098
TOTAL EXPENSES	-ROL 12,154,964	-ROL 23,022,986	-ROL 17,516,253	-ROL 9,936,753	-ROL 6,502,785	-ROL 1,326,852		-ROL 70,460,593
Anticipated Defaults (b):	ROL 44,825	ROL 133,470	ROL 131,032	ROL 115,565	ROL 100,097	ROL 75,573	ROL 13,030	ROL 613,592
CASH FLOW	**-ROL 102,037,311**	**-ROL 15,731,835**	**ROL 41,703,892**	**ROL 42,292,745**	**ROL 38,736,067**	**ROL 32,828,470**	**ROL 5,888,739**	**ROL 43,680,767**
Discount Rate:	**6.04%**	(Weighted Average Cost of Capital).						
NPV in 000s Romanian Lei:	**14,096,814**							
Euro Equivalent of the NPV	**€345,569**							
IRR	**10.0%**							
Assumptions:								
a) Assumed default rate:	0.222%							
b) Overhead expense	2.03%							
c) G&A rate was calculated from data of KPMG audit 2003								
d) Exchange Rate: Euro 1=	ROL 40.793							
e) Cost of funds is a projection based on projection of WACC.								
f) Client Loan Rate is an average rate calculated from estimated rates for ROL loans in 2005 -2011.								

2.0 Borrower Analysis

Target Market

The $5 million loan guarantee facility will be targeted toward municipal governments for energy and water/wastewater efficiency improvement and the rehabilitation of networks and equipment. Loans will finance efficiency and capital improvements on a variety of infrastructure projects including water supply, wastewater disposal, district heating systems, etc. These investments are expected to significantly improve energy efficiency, in water/wastewater and district hearing systems, reducing unit operating costs and contributing to improved financial performance and reliability of supplies at affordable prices. Connections to centralized district heating systems have shrunk to about 31% of the Romanian population due to poor service quality and high cost of services. Investments needed for repairing and upgrading of existing centralized district heating systems would reach Euro 6,600 million in the next ten years. Data on targeted municipalities was not readily available, so we provide below a general description of the operating environment and the legal and institutional structures which impact municipal finance in Romania.

Another good potential area for commercial lending is implementing energy efficiency programs with homeowners associations. During 2000-2003 around 600,000 apartments have voluntarily disconnected from the centralized district heating systems and installed their own more efficient hot water and heating systems.

Potential for involvement of ESCOs is less clear. This is due to the fact that ESCOs are still evolving in Romania and have yet to develop the necessary skills and financial expertise to assist both the public and private sector.

Municipal and Municipal Enterprises Operating Environment

Most water/wastewater and district heating utilities in Romania are owned and operated by municipalities or cities. A minority of water and wastewater utilities may remain under State ownership. All water/wastewater utilities are viewed as municipal enterprises, which are subject to price, tax and licensing regulation.

States and local ownership and regulatory powers create a specific risk profile for municipal lending in Romania. Electricity and heat produced by cogeneration (reference price) tariffs are set countrywide by the regulatory body ANRE, but the prices for heat delivered by district heating systems are established by the executive body of the local governments or by the state administration in the case of State ownership. The difference between real costs and the reference price is covered through subsidies provided by central (55%) and local (45%) budgets. The State, however, retains the authority to establish the rules for tariff setting for natural monopolies (transport and distribution.) The State also identifies the systems for redistributing costs between groups of consumers and defines rules for enforcement at the local level, with respect to service quality, safety, labor conditions, tax payment, and/or allocation and use of budget funding provided to the utilities.

The specific risks facing potential municipal borrowers under the DCA facility, as a result of the distribution of regulatory powers between the State and the municipalities, are as follows:

Risks related to the State:

- Price inflation in excess of that included in current financial projections, especially with respect to prices for energy and labor;
- Unexpected tax penalties or liabilities resulting from frequent changes in the laws on VAT, Enterprise Profit Tax, Income Tax, Mandatory State Pension Insurance and Mandatory State Social Insurance;
- Unknown legislative changes that could complicate the process of applying for loan financing (e.g. requiring registration of debts incurred by municipalities with the State Government); and
- Inadequate subsidies from the State.

Risks related to the Municipalities:

- Failure to approve future cost-recovery tariffs, when and if costs rise above revenues; and
- Failure to generate sufficient subsidies through the local budget.

Overall, the operating environment for increased municipality penetration into credit markets is considered favorable. The two most significant factors determining the creditworthiness of an individual municipality borrower – the power to approve cost-recovery tariffs and to enforce payment collection – are under the municipality's control. Pending legislative changes are not expected to produce an adverse effect on the financial position of the participating borrowers.

Municipal Legal and Institutional Constraints

Legal Framework and Control

The legal and regulatory framework, which defines the operating environment for prospective municipal borrowers, is summarized in the following paragraphs to provide context for the financial projections that will follow.

The Constitution of 1991 fundamentally changed the juridical philosophy of local authorities, with separation of local councils, mayors and county councils as authorities of the territorial units (*judete*, *municipii*, *orase* and *commune*) and the 'Prefect" as a local representative of Central Government. The main laws regulating local authorities in Romania are:

- Law 215/2001 on local public administration
- Law 189/1998 on local public finance (to be replaced by Government Ordinance No. 45/2003)
- Law 522/2002 on local taxes and duties (approving Government Ordinance No. 36/2002.)

Law 215/2001

Law 215/2001 defines the status of local authorities based on the principles of local autonomy and decentralization of public services. The law grants local authorities the right and authority to decide on local public matters.

Law 189/1998

Law 189/1998 provides the principles, general framework and procedures regarding the administration and use of local public funds and defines the competencies and responsibilities of local governments at both local and country level. Government Ordinance No. 45/2003 addresses certain shortcomings of this law and defines more precisely the revenue sources and the legal borrowing procedures for local authorities.

Law 522/2002

Law 522/2002 sets forth the legal framework for local taxes and duties, defining the categories and bands of such taxes.

The application of these three main laws creates a reasonably favorable environment for municipal borrowing. The County Court controls all actions of local authorities (mayors, local councils, county councils.) The Prefect, as the representative of Central Government, has the authority to file for annulment in the County Court against any local authority decision he/she deems illegal. Pursuant to Law 215/2001 on public local administration, the Prefect exercises control with respect to all administrative acts adopted or issued by local authorities and country authorities, excluding day-to-day management.

The financial decisions of the local authorities, on both expenditure and borrowing, are subject o *a priori* control exercised within the institution by the finance and accounting departments. *A priori* financial control is exercised by persons within such department, appointed by the head of the public institution. This control concerns the legality, accuracy and, as the case may be, the conformity of the controlled operation within the limits and designation of budgetary credits. The use of public funds is subject to approval of the credit manager. The main credit managers are the mayor, the president of the local council and the president of the county council. The secondary and tertiary credit managers are the directors of the public institutions subordinated to principal credit managers. The Ministry of Public Finance exercised control over the activities of the credit managers.

The Court of Accounts exerts an external, *a posteriori*, control. The Court of Accounts is an independent institution reporting to the Romanian Parliament. Such control regulates the distribution, administration and use of the financial resources of the State and of the public sector, as well as the management of the public and private patrimony of the State and of the territorial administrative units. The Court also has jurisdictional competency on claims pertaining to the distribution, administration and use of the financial resources of the local authorities and the management of their patrimony. In the territorial administrative units, the court supervises the local Chambers of Accounts. The Court is headquartered in Bucharest.

Finances and Revenue

Government Ordinance 45/2003 (clarifying Law 189/1998) on local public finances defines the revenue sources of local authorities. Revenue sources include taxes, duties, contributions, shares in general income tax, State transfers, State subsidies and Other Revenue sources. Law 522/2002 provides for several local taxes and fees, which in 2002 accounted for 18 – 20% of total recurrent revenues. These include taxes on buildings, land and vehicles and fees on building warrants, public space advertising, and fees on hotel occupancy. Local property taxes, on land, buildings and vehicles, and other user fees are set within narrow banks proscribed by the Government.

The tax sharing system is regulated by Law No. 215/2001 on local public administration, G) 45/2003 on local public finance and by annual budget laws. The local councils receive a share of general income tax collected from taxpayers in their area of jurisdiction. Both the base and rate are set by law; the revenue split is determined by Central Government pursuant to legislation. General income tax is collected at source and transferred on a monthly basis – therefore fairly predictable. However, local governments cannot control the base, rate or collection. As an illustration, the total sums allocated to Iasi municipality represented 21% of total revenues in 2002 and 30% in 2003.

Government transfers are assigned to counties in the first instance and then these are distributed to the local authorities. The main quantitative criteria for the transfer from the State to the County level are: 70% in proportion to the financial capacity and 30% in proportion to the size of the county.

17% of general income tax is transferred in the first stage to the county budget and later to local budgets (together with aforementioned equalization grants.) Although the 17% share in general income tax is a legally fixed amount (annual budget laws can only increase the percentage), it is not a shared tax for two reasons. Firstly, it is not directly transferred to local budgets and, secondly, the allocation criteria are not fully automatic. 25% of the equalization fund, consisting of the 17% equalization share in income tax and equalization transfers, remains in the country budget and 70% is allocated to local budgets in proportion to a combination of financial capacity (30%), size of local unit (30%), population (25%) and other criteria (15%.)

Other transfers from the state budget are granted for investments financed from external loans and are annually approved in the State Budget law. Shares in VAT are allocated yearly through the Annual National Budget (since 2001) and are discretionary – set by the Central Government and earmarked. Non-tax revenue consists mainly of earnings from real estate leases and use and sale of assets.

Expenditures

Typical municipal expenditures are grouped into the following categories:

- General administration – salaries, operating and capital expenditures funded from own source revenues;

- Education – funding of primary and secondary state education teacher salaries, operating and capital expenditures – with addition support from state grants to local budgets. This is one of the most significant expenditure items in local budgets;
- Health - operating and capital expenditures - supported by an earmarked subsidy from targeted grants;
- Cultural institutes;
- Religion – salaries for lay teachers – supported by an earmarked subsidy;
- Public services – maintenance and repair of streets, street lighting, sanitation, maintenance of parks, waster supply, sewerage, district heating and power plants – fully funded at the local level;
- Roads – funded by a special fund;
- Local transport – quantity and quality standards – fully controlled by local authorities;
- Social welfare – partly or fully funded mandates;
- Services for the disabled – central regulated and partially supported by targeted grants;
- Minimum income support – for persons below the poverty level – funded locally;
- Private Producer Subsidy for residential heating distributed to local councils – district residential heating is subsidized from shared amounts of personal income tax allocated to county councils in relation to the quantity of heating provided to the population. The base price for heating is established by the State – the difference between this and local production costs are subsidized from local budgets;
- Heating vouchers – targeted support schemes based on means testing of the residents with centrally determined caps – funded from local budgets; and
- Housing – supported by some central funding.

Illustrative examples

As mentioned previously, the pipeline of energy efficiency projects is not yet fully developed in Romania. There are a number of ongoing programs that are working to identify and further develop project ideas, which will then represent a pool of possible projects to be funded under the DCA guarantee. We have identified three projects, which we discuss briefly below, that represent illustrative examples of the type of projects that will be seeking financing in the near term.

Project Bistrita – Combined Heat and Power Project[3]

The City of Bistrita is located in Transylvania in northern Romania and has a population of 86,000. Romania recognizes Bistrita as an important city because of its economic output and strong cultural traditions. Bistrita's existing power plant is located near an industrial wood and furniture manufacturing enterprise and there are several other textile and equipment manufacturers in the surrounding area. The heavy oil-fired plan generates steam and hot water for the City. The existing plant's steam generation boilers are approximately 25 years old and the heavy oil fuel has a negative environmental impact. The City is therefore planning a new gas fired Combined Heat and Power (CHP) power plant that will be an efficient cogeneration plant utilizing cleaner fuel. This project will be eligible for green house gas emission reduction credits, as it will improve energy efficiency and will have a positive environmental impact.

[3] Data on the Bistrita project was obtained from Mr. H. Pitaru, Executive Director, Romania Energy Policy Association

The scope of the project includes replacement of old tubular heat exchangers with efficient plate exchangers; installing 2,000 new metering systems; installing electronic gas consumption meters and static converters for frequency; and replacement of three gas fired engines and 5.3 km of thermal networks with pre-insulated pipes. Pre-feasibility studies have been carried out by OVM/ECH Consulting Engineers of Germany and I.S.P.E. Timisoara, and the EBRD has provided some technical assistance to the project (until 2001.) Based on current legislation, this municipality and its other partners may operate as an Independent Power Producer (IPP.) This structure would involve an auto-producer to finance or fund at least 10% of the project cost and to utilize at least 50% of the generated power or heat.

The total cost of the proposed project is estimated at $3.1 to $3.4 million, with an expected life of 10 years. The current financing plan includes a total of $1.02 million in grants (from the Municipality itself and Kyoto Protocol emission reduction units) and $2.38 in loan financing, of which approximately $1 million is expected to come from local industries and foreign partners, and $1 million from commercial banks.

Municipality of Topoloveni – Rehabilitation of 48 Multi-Family Buildings for Energy Savings and Energy Efficiency[4]

The municipality of Topoloveni, located in Arges County, is seeking to partially rehabilitate 48 multi-family buildings. UNDP-GEF contracted TRAPEC SA to complete a feasibility study in May 2004 to identify an optimal technical solution to improve energy efficiency. Generally, the residential apartments are 14 to 24 years old, and all families pay the heat bill to the municipal district heating company, which is owned and operated by the municipality. Due to the continually increasing costs of municipal energy bills, five of the 48 buildings have decided to install individual heating systems. The Topoloveni district heating plant and heating grid are characterized by diminished boiler efficiency, grid leakages caused by erosions, and the lack of meters and thermostats at source and end-user locations.

The scope of the project includes thermal insulation of the flat room and protection by a metallic roof, replacing wood window frames with modern PCV frames and double windows in all staircases, replacing the external metallic doors with modern PCV frames and double windows at all entrances, and added mineral protection under the ground floor.

The $3.45 million total cost of the proposed project is expected to result in energy savings for a minimum of 15 years. The feasibility study estimated potential energy savings of approximately €800,000 per year. The preliminary financing plan would include 45% financing through homeowners, State and Municipal Governments and 55% (or approximately $1.89 million) through a commercial bank loan.

[4] Data on the Topoloveni project was obtained from Mr. Mark Velody, Project Manager, UNDP, UNOPS Project Office, Romania

Municipality of Mangalia – Rehabilitation of Heat and Hot Water Generation Plants[5]

Mangalia is a well-known Black Sea summer resort. At present, Mangalia is the second largest harbour in Romania and has 50,000 inhabitants. The town's economy depends heavily on harbour activities but also has significant tourism inflows from the satellite communities of Olimp, Neptun, Jupiter, Venus, Cap Aurora and Saturn. Mangalia's existing heat and hot water generation plants supply the residential sector, public institutions and commercial enterprises and office space. The plants' equipment is over 30 years old and utilizes liquid fuel (CLU type 3.) The average efficiency of the boilers is approximately 60% and the total installed capacity amounts to 61.6 MW thermal (52.95 Gcal/h.). Two of the plants have already been modernized and nine plants need modernization. The heat distribution grid was developed around the same time as the plants and presently has substantial thermal losses of over 25%. 30 km of transport grids need rehabilitation and the circulation pumps also require replacement.

The scope of the project includes rehabilitation of the nine plants, as well as the heat grids and circulation pumps. The Municipality has developed a step-by-step rehabilitation program and expects to rehabilitate all nine plants within the next few years. The Municipality currently does not have the resources to finance the entire $13.3 million, but is interested in phased rehabilitation of a few plants at a time. For example, to rehabilitate plants 2, 6 and 8 as a bundled transaction would cost $5.4 million.

The $5.4 million total cost of the proposed project would have an expected life of 10 years. The preliminary financing plan would include $2.16 million from the local budget, $ 1 million from special loans and grants, and a $2.16 million bank loan.

Detailed Financial Analysis – Magnalia Project

Because of the limited detailed financial information available on the existing projects, we have selected one project – the Magnalia Project– and provide an illustrative cash flow projection and analysis below.

Project Costs

As summarized above, the rehabilitation of heat and hot water generation plants in Mangalia is expected to cost $13.3 million in total, detailed by plant as follows:

PLANT	US $ million
1	1.05
2	1.45
3	0.92
4	1.36
5	1.34
6	1.96
7	2.04
8	1.95
9	1.20
Total	**13.3**

[5] Data on the Mangalia project was obtained from Ms. Liana Hanganu, Executive Director, Romanian Fund for Energy Efficiency (FREE)

The municipality is interested in a phased rehabilitation of a few plants at a time. Therefore, for purposes of this illustrative analysis, we have assumed that plants 2, 6 and 8 are bundled together for rehabilitation. The total investment for these three plants is $5.4 million, with an expected life of 10 years.

Projected Cash Flows – Source of Savings

Because the existing plants are about 30 years old and have a very low boiler efficiency (less than 60%), present operational costs including fuel consumption and thermal losses are high and contribute to high unit costs. Rehabilitation or modernization of these plants will result in significant savings in operational costs as well as reduced environmental impact. Also, over the last several years there has been a trend for commercial and residential customers to disconnect from the district heating grid and install individual systems. Rehabilitation of the Mangalia system will result in substantial operational cost savings and also instill confidence in consumers to utilize the district heating system. A feasibility study conducted by a consulting firm for Mangalia estimates that the rehabilitated system will be much more efficient and generate higher revenues. This is reflected by the positive project cash flows presented at Table 1.

Financing Plan and Identification of Investors

The preliminary financing plan calls for the following sources of funding:

Local Budget (40%) -	$2.16 million
FREE[6] Loan (10%) -	$0.54 million
FDSEN Grant (10%) -	$0.54 million
Bank Loan (40%) -	$2.16 million
Total	**$5.40 million**

Key Assumptions

The following are the key assumptions in the financial analysis:

- Project capital costs of $5.4 million
- Operations & Maintenance costs - $525,000 per year escalated at 3% per annum
- Revenues from sale of heat and hot water - $2.62 million escalated at 2% per year
- Grants $2.7 million
- Loans $2.7 million
- Loan period – 5 years
- Project equipment life – 10 years
- Volksbank cost of funds 4% (Euro-based)
- Interest rate 17% (Euro-based)
- Discount rate 10%

[6] FREE is the acronym for the Romanian Fund for Energy Efficiency

Summary of Conclusions

Project summary cash flow projections are presented in the table on the following page. In the base scenario, the project has an Internal Rate of Return of 14.53% on a cash basis over the life of the project (defined as 10 years based on the useful life of the equipment.) The cost of debt financing is estimated at an annual rate of 17%, which is consistent with the lower end of interest rates projected by Volksbank in Romania. The IRR suggests that the project is producing a desirable return when compared to the cost of capital. Also, the project NPFV is positive at €420,418 that makes the project financially attractive. The discount rate of 10% represents the borrower's required return on investment. A sensitivity analysis, included at Table 1B, demonstrates the resilience of the financial measures to changes in free cash flows and interest rate assumptions.

Attachment IV: Financial Viability Analysis
Office of Development Credit, U.S. Agency for International Development
Loan Portfolio Guarantee for Municipal Credit – USAID/Romania

Table 1
Financial Viability Analysis for Volksbank (Euro Portfolio)

Rehabilitation of Mangalia Heat Generation System

Bank Assumptions			Project Assumptions	
Financial Viability Analysis	Volksbank		Project Revenues	2,140,540
Total Capital Cost	4,411,800		Annual Revenue Growth	2%
DCA Coverage	50%			
Guaranteed Amount	2,220,590		Operations & Maintenance Costs	428,925
Assumed Loan amount in Euro	2,191,210		Annual Ops. & Maintenance Growth	3%
Guaranteed Amount for US$ Portfolio	1,095,605			
Term in years	5			
Cost of Funds	4.00%	apr		
Client Loan Rate	17.00%	apr		
USAID Coverage of Defaults	3.00%			
Commitment Fee	0.375%			
Utilization Fee	0.50%	*per annum*		

Project Cash Flows (by Year):	**1**	**2**	**3**	**4**	**5**	**6**	**7**	**8**	**9**
Initial Capital Outlays	**0**	**-**	**-**	**-**	**-**	**-**	**-**	**-**	**-**
Project Cash Flows	2,140,540	2,183,351	2,227,018	2,271,558	2,316,989	2,363,329	2,410,596	2,458,808	2,507,984
Operations & Maintenance Costs	(428,925)	(441,793)	(455,047)	(468,698)	(482,759)	(497,242)	(512,159)	(527,524)	(543,349)
Loan Amortization	(667,915)	(667,915)	(667,915)	(667,915)	(667,915)	-	-	-	-
Defaults	-	-	-	-	-	-	-	-	-
Net Project Cashflows	1,043,700	1,073,643	1,104,057	1,134,946	1,166,316	1,866,087	1,898,437	1,931,284	1,964,634

Discount Rate: **10.00%** (Weighted Average Cost of Capital)
Project's NPV in Euro: **8,697,212**

Bank Cash Flows (by Year):	**1**	**2**	**3**	**4**	**5**	**6**	**7**	**Total**
Disbursements	2,191,210	0	0	0	0	0	0	2,191,210
Inflows:								
Principal Repayment	667,915	667,915	667,914.58	667,914.58	667,914.58	-	-	3,339,572.88
Interest Payment	359,951	305,372	241,120.33	165,481.72	76,438.06	(0)	(0)	1,148,362.88
USAID Coverage of Defaults@ 3.0%	0	0	0.00	0.00	0.00	-	-	0.00
Inflows Less Disbursements	-1,163,345	973,287	909,034.90	833,396.29	744,352.63	(0)	(0)	2,296,725.75
Outflows:								
Interest Expense	-78,535	-64,601	-48,198	-28,888	-6,156	0	0	-226,378.83
Overhead Expenses@ 2.0%	-8,765	-8,765	-8,764.84	-8,764.84	-8,764.84	-	-	-43,824.20
Fees								
USAID Commitment Fee	-8,217	0	0	0	0	-	-	-8,217.04
USAID Utilization Fee	-10,956	-10,956	-10,956	-10,956	-10,956	-	-	-54,780.25
TOTAL EXPENSES	-106,473	-84,322	-67,919.20	-48,609.11	-25,876.78	0	0	-333,200.32
Anticipated Defaults (b):	0	0	0.00	0.00	0.00			0.00
CASH FLOW	**-1,269,818**	**888,964**	**841,115.70**	**784,787.19**	**718,475.85**	**0.00**	**0.00**	**1,963,525.43**

Discount Rate: **10.00%**
IRR: **14.53%**
Bank's NPV in Euro: **420,418**

Assumptions:	
a) Assumed default rate:	3.0%
b) Cumulative overhead expense (allocated over term of loan)	2.0%

c) This analysis assumes that all funds will be disbursed in Euro.
d) See cost Analysis sheet for annual project operations & maintenance costs
e) See cost analysis sheet for annual revenue stream

Table 1b
Sensitivity Analyses for Mangalia Project

NPV Sensitivity Analysis

	% of Free Cash Flows				
	80%	**90%**	**100%**	**110%**	**120%**
Discount Rate Factor of 10%	(103,551)	158,433	420,418	682,402	944,386
Discount Rate Factor of 11%	(186,352)	65,283	316,917	568,552	820,186
Discount Rate Factor of 12%	(264,015)	(22,089)	219,837	461,764	703,690
Discount Rate Factor of 13%	(336,943)	(104,132)	128,678	361,489	594,299
Discount Rate Factor of 14%	(405,498)	(181,256)	42,985	267,226	491,467

IRR Sensitivity Analysis

	Loan Interest Rate				
	13%	**15%**	**17%**	**19%**	**21%**
Bank Cost of Funding of 2%	11.4%	13.4%	15.4%	17.4%	19.4%
Bank Cost of Funding of 3%	11.0%	13.0%	15.0%	17.0%	19.0%
Bank Cost of Funding of 4%	10.5%	12.5%	14.5%	16.5%	18.5%
Bank Cost of Funding of 5%	10.1%	12.1%	14.1%	16.1%	18.1%
Bank Cost of Funding of 6%	9.7%	11.7%	13.7%	15.6%	17.6%

Attachment V: Fee Justification

Project Description
The proposed portfolio guarantee facility will be extended by the U.S. Government to specified Romanian private commercial banks demonstrating the willingness and ability to make loans to municipalities for capital improvements. Participating banks will receive guarantees on up to 50% of the capital amount of loans to the municipalities.

The guarantee acts as an incentive to banks to lend to the municipalities, municipal enterprises and perhaps ESCOs. Banks have indicated that as a result of the guarantee, they are willing to offer municipalities longer loan terms and lower interest rates. These attractive conditions will encourage municipalities to come forward and apply for loans to rehabilitate their deteriorated physical assets.

The total capital amount of loans that can be guaranteed under the facility is $ 5.0 million; the maximum amount of any one loan under the Municipal DCA is $ 1.0 million.
It is expected that the DCA facility will result in increased access to financing by municipalities for energy-efficient capital investments and greater financial autonomy.

Proposed Fee Structure

It is proposed to charge participating banks the following fees:

Origination fee: 0.375% one-time flat fee based upon the amount of the Guarantee Ceiling

Utilization fee: 0.50% per annum fee, payable semi-annually, based upon the average outstanding balance of the guaranteed portion of loans outstanding.

Any fees higher than this rate would serve as a disincentive for a bank to participate in the proposed DCA. In addition, it is considered that the market could not bear higher fees, since participating banks will in all likelihood pass on these fees to potential borrowers.

Attachment VI: Legal Terms and Conditions

<u>GUARANTEE TERM SHEET</u>

GUARANTEE PURPOSE. The USAID guarantee is intended to strengthen the Guaranteed Party's ability to finance loans to municipal governments, municipal corporations and agencies or private energy service companies in Romania for revenue-generating or cost-reducing infrastructure projects, such as for investments in projects improving energy efficiency, water supply, or waste water treatment.

THE GUARANTEE. To induce the Guaranteed Party to make "Qualifying Loans" to "Qualifying Borrowers" for "Qualifying Projects," as defined below, the Parties agree to the following terms:

1. <u>Maximum Authorized Portfolio Amount</u>: The aggregate principal amount of all Qualifying Loans covered under this Agreement at any one time shall not exceed the Romanian Lei ("RL") equivalent of Five Million U.S. Dollars ($5,000,000).

2. <u>Maximum Cumulative Disbursements</u>: The maximum cumulative amount of all loan disbursements made under Qualifying Loans shall not exceed the RL equivalent of Five Million U.S. Dollars ($5,000,000). No loan disbursement shall be eligible for coverage under the Guarantee unless the amount of such disbursement, together with all previous disbursements made under Qualifying Loans, does not exceed the RL equivalent of Five Million U.S. Dollars ($5,000,000).

3. <u>USAID Guarantee Percentage</u>: Fifty (50%) percent of the Guaranteed Party's net losses of principal. (See Section 4.01 of the Standard Terms and Conditions for claim requirements.)

4. <u>Guarantee Ceiling (Maximum USAID Liability)</u>: US $2,500,000.

5.<u>Final Date for Placing Qualifying Loans under Coverage</u>: Five (5) years after the date of signature of this Agreement by the Parties.

6. <u>Coverage Expiration Date</u>: Seven (7) years from the date of the Agreement.

7.<u>Final Date for Submitting Claims</u>: Six (6) months after the Coverage Expiration Date, except as set forth in Article IV of the Standard Terms and Conditions attached hereto, provided further that no claims may be submitted in connection with any default on a loan that occurs after the Coverage Expiration Date.

8. <u>Currency of Qualifying Loans Placed Under Guarantee Coverage</u>: RL.

9. <u>Currency of Guarantee Payment</u>: RL.

10. <u>USAID Guarantee Fees</u>:

10(a). <u>Origination Fee</u>: one-half percent (1/2%) of the Guarantee Ceiling, equal to US $12,500.

10(b).Utilization Fee: one-half percent (0.375%) per annum of the average outstanding principal amount that is guaranteed by USAID. This amount is to be calculated by taking the USAID guaranteed portion (50%) of the average of the total ending balances of all Qualified Loans at the end of the two most recent Guarantee Periods and then multiplying such amount by one-half percent (0.5%) per annum. The fee is payable semi-annually, as billed.

11. Currency of Fee Payment: RL or U.S. Dollars.

12. Guarantee Periods: The first Guarantee Period will commence upon the date of the Agreement and end on September 30, 2004. Subsequent Guarantee Periods will consist of each six month period, beginning with the six month period from October 1, 2004 to March 31, 2005 and the final Guarantee Period will commence April 1, 2011 and end on the Coverage Expiration Date.

CRITERIA FOR QUALIFYING LOANS. In addition to the criteria set forth in the Standard Terms and Conditions, Attachment 2, a "Qualifying Loan" is one made to a "Qualifying Borrower" for a “Qualifying Project”, each as defined below:

13. Qualifying Borrowers: Credit-worthy municipal governments of Romania, municipal corporations or agencies, or private energy service companies in Romania, provided that, to the satisfaction of the Guaranteed Party, all relevant local and international authorities have issued any approvals necessary to permit lending in the municipal sector.

14. Maximum Cumulative Principal Amount of Qualifying Loans Made To Any One Qualifying Borrower: The RL equivalent of U.S. $1,000,000. A Qualifying Borrower includes any Affiliate of that borrower, including parent or subsidiary companies having the same or substantially similar ownership as such borrower. Any question regarding who is a Qualifying Borrower may be resolved in consultation with USAID, and USAID may waive in writing this restriction on loans to Affiliates. USAID shall approve in writing all loans over the RL equivalent of U.S. $1,000,000 before they are placed under coverage of the guarantee. The minimum size of a loan which may be placed under coverage is the RL equivalent of U.S. $200,000, at the time the loan is made.

15. Qualifying Projects: Investments of municipalities, municipal corporations or agencies, or private energy service companies that support revenue-generating or cost-reducing infrastructure projects, such as projects supporting energy efficiency, or improved delivery of utilities including water, or improved waste water treatment.

16. True Risk Sharing by Guaranteed Party: In order to ensure that there will be true risk sharing between USAID and the Guaranteed Party, no Qualifying Loan shall be eligible for coverage under the Agreement if more than fifty percent (50%) of total payments of principal on such Loan is guaranteed by a government or international donor organization, including USAID or the EBRD.

17. Payment Instructions:

(1) Payments to USAID in U.S. Dollars should be made directly to the U.S. Department of Treasury's account with the Federal Reserve Bank of New York via electronic funds transfer for further credit to USAID.

Please be sure to include following information in the wire transfer instructions:

Federal Reserve Bank of New York ABA# 021030004
U.S. Department of Treasury - Type Code 15
USAID Agency Location Code (ALC) 72000001
Reference: USAID a/c 72X4266, bank name (to be inserted),
Guarantee No. (to be inserted)

(2) Payments to USAID in local currency should be made directly to the USAID Controller or

USAID Cashier in-country via check, applying the same reference number as stated above.
NOTE: USAID will no longer be using the SWIFT system for local currency payments.

18. Address for Notices:

USAID:
USAID/Romania
Opera Center, 4th floor, Sector 5
1-5 Costache Negri Street
Bucharest
Romania
Tel: 40-21-410-1222
Fax: 4021-410-1202
Attn: Director, Democracy Office

GUARANTEED PARTY:

Volksbank Romania
8 Coltei Street, Sector 3
Bucharest, Romania
P.O. Box 37-91

Tel: 40-21-303-93-04
Fax: 40-21-303-93-92
Attn: Mr. Gerald Schreiner, VP
USAID FINANCIAL AGENT:

Riggs Bank N.A.
808 17th Street, N.W.
P.O. Box 96206
Washington, DC 20090-6206
Tel: 1-202-835-6746
Fax: 1-202-835-4303
Attn: Mr. Earl Ziegler, Jr.
Specialized Client Services

19. **Definitions**: When used in the Standard Terms and Conditions (Attachment 2), each underlined term defined in paragraphs 1 through 18 above shall have the same meaning as provided to such term in this Guarantee Term Sheet.

Attachment VII: Risk Assessment

USAID TO INSERT

Attachment VIII: Subsidy Cost Calculation

USAID TO INSERT

Attachment IX: Monitoring Plan

Monitoring is a coordinated effort between the Mission and the Office of Development Credit (EGAT/DC). Monitoring responsibilities are divided into Development and Financial activities. The Mission is solely responsible for Development Monitoring while EGAT/DC and the Mission are both responsible for Financial Monitoring.

Development Monitoring

The Mission will monitor the developmental aspects of this activity. The Municipal DCA guarantee supports the performance of the Strategic Objective 1.3 and will be measured by the indicators presented below.

Strategic Objective 1.3	<u>Quantifiable Measures of Benefits</u> • Annually review and determine number of loans and the amount of loans disbursed by Volkbank for the energy efficiency and municipal water supply sectors utilizing the DCA Instrument. • Effective 2006, on an annual basis, review the energy savings realized related to financing or cofinancing of the DCA instrument with potential partners such as UNDP, FREE, RAEF, etc.

The Mission and its implementing partners will obtain loan data from partner banks. The Mission with implementing partner will 1) verify that data have validity, integrity, precision, reliability, and timeliness; 2) ensure that data collection and analysis procedures are consistently applied over time; 3) maintain accessible and current documentation; and 4) report on data quality limitations in the Mission's annual report. This will be done through regular meetings held at the partners' offices; site visits to regional activities, data quality assessment surveys, review of survey designs, and data quality spot checks.
The Mission and its implementing partners will collect the information for this indicator by reviewing city government information and/or statistical reports with specific data on services improvements, by reviewing existing opinion polls of citizens/businessmen, and through direct measurement data.

Financial Monitoring

Financial Monitoring activities include ensuring that fees are paid, reporting requirements are met, documenting completion of conditions precedent (when applicable), making site-visits, and closing out the facility upon expiration. The EGAT/DC Portfolio Management (PM) team takes primary responsibility for Financial Monitoring. EGAT/DC will create and manage source files for all DCA facilities and be the primary resource for financial reporting on DCA activities within the Agency.

The coordinated effort in monitoring requires that the Mission and EGAT/DC staff work as a team. The Mission establishes and maintains the primary relationship with the partner financial institution (FI), or guaranteed party, and acts as the liaison between the FI and the EGAT/DC in Washington. The liaison role is supported by the EGAT/DC Project Development (PD) team Relationship Manager who together with the Mission ensures:

- Frequent contact with the FI's management;
- Timely and compliant submission of required documents and reports;
- Prompt remittance of USAID origination and utilization fee payments from FIs; and
- Communication with EGAT/DC Portfolio Management if problems arise or certain conditions change that either reduce or improve the financial stability of the FI or the Borrowers.

This monitoring plan outlines detailed requirements for Financial Monitoring activities. A monitoring plan may include additional monitoring duties if deemed necessary by Mission Officer(s) responsible for a DCA activity and/or EGAT/DC Relationship Managers. These additional duties may arise due to the particular structure of the guarantee facility, the status of the guaranteed party or the desired development outcomes. The duties detailed below are performed throughout the life of the guarantee facility. Each monitoring activity must be conducted according to this monitoring plan. The EGAT/DC PM team will ensure that the DCA files in Washington are maintained to document all monitoring activities as outlined in this plan.

Reporting

For examples of any of the following reports, templates should be included as an attachment to the legal agreement signed between USAID and the guaranteed party. Prior to signing this agreement, Missions should contact EGAT/DC for examples/templates.

i. QUALIFYING LOAN SCHEDULE (QLS)

The guaranteed party will submit a Qualifying Loan Schedule (QLS) every six months.[7] Typically, these QLS reports correspond with guarantee periods from October 1 – March 31, and then April 1 through September 30. The QLS is a status report on all new loans placed under coverage, outstanding loans, and loans taken off coverage during the past six months. The summary level figure of each QLS that is most important from the utilization and USAID risk exposure perspective is the ending principal balance.

EGAT/DC ensures financial compliance of every QLS and it will report any non-compliance to the Mission for resolution or directly discuss these issues with the guaranteed party if previously agreed to by the Mission. QLS non-compliance may occur frequently if the guaranteed party does not fully understand reporting procedures or the legal agreement terms and conditions. In some cases, several email and/or telephone communications may be necessary to resolve non-compliance issues. Furthermore, a Mission or EGAT/DC site visit to or meeting with the guaranteed party may be required if the issues remain unresolved for more than 60 days.
Once in compliance, the QLS serves as a platform to assess appropriate fees, judge the overall risk exposure, document the overall effectiveness of the program, and/or predict future claims.

[7] The current standard for loan and bond guarantee reporting requirements are annual, corresponding with the amortization or repayment of the loan/bond.

For LPGs, QLS reports are submitted via the Internet-based Credit Management System (CMS). For other loan and bond guarantees, the guaranteed party will submit either electronic or paper reports, which typically include updated amortization or repayment schedules, as stipulated in the legal agreement. EGAT/DC will ensure those reports are properly entered into CMS for management reporting and utilization fee billing purposes. Missions, guaranteed parties and EGAT/DC will have simultaneous access to CMS to view data and to identify either compliant or non-compliant issues.

ii. FEES

Each DCA activity requires that the guaranteed party remit payment of two types of fees. As stated above, it is the responsibility of the Mission and the EGAT/DC Relationship Manager to ensure timely and accurate payment of fees.

a) Origination Fee – One time fee paid upfront. The guaranteed party typically has thirty (30) days to pay this fee as instructed in the legal agreement. A bill will not be submitted to the Mission or to the guaranteed party. Payment must be made as instructed in the legal agreement. See legal agreement for further information. In regards to the majority of PGs, the identified borrower(s) will pay the origination fee as stipulated in its commitment letter, which serves as the obligating document for this type of guarantee.

b) Utilization Fee – Annual fee that is paid every six months. The fee is based on an average outstanding principal balance during a semiannual period. This is typically calculated by averaging the ending principal balance of the current and previous QLS reports submitted by the guaranteed party. Once QLS report balances are confirmed as compliant by EGAT/DC in CMS, EGAT/DC will contact Riggs Bank to ensure a bill, a “Notice of Payment Due” (NPD) is sent to the guaranteed party with the total amount to be paid. The guaranteed party has thirty (30) days to pay the utilization fee after it receives the NPD. See legal agreement for further information. In regards to PGs, the commitment letter will not entail any utilization fees, which would be paid by the eventual guaranteed party that provides a loan to the borrower. Also, for bond guarantees, utilization fees are typically paid upfront in one lump sum at the time of bond disbursement. This fee is calculated as a net present value of future fees based on forecasted outstanding amounts during the bond guarantee term.

iii. ANNUAL DATA QUESTIONNAIRE (ADQ)

Through CMS, EGAT/DC will request that guaranteed parties complete an ADQ by June 30 every year. CMS will generate emails to the key contacts of all guaranteed parties on or around June 1 to request that they complete the ADQ before the end of the month.
The purpose of this questionnaire is to obtain further quantitative and qualitative measures of the impact of DCA guarantees. Examples of the questions asked in the ADQ are:

- Percentage of loan(s) disbursed in target sectors(s).
- Aggregate number of employees at the businesses with guaranteed loan(s).

- Examples if the DCA guarantee allowed the guaranteed party to lower collateral requirements to approve the loan.
- Example of a "success story" of the tangible benefits realized by one of the borrowers who productively utilized funds from a DCA guaranteed transaction.

The guaranteed party is requested to use actual data to complete the ADQ, but estimates are acceptable. ADQ guidance in CMS will recommend that the guaranteed party spend no more than 30 minutes on the ADQ to ensure that this request is not overly burdensome.

iv. CLAIMS

The following list highlights how DCA claims are processed:

- Guaranteed party submits claim(s) for defaulted loan(s) to the Mission under a covered DCA facility. When the Mission receives the claim, it should forward the documentation to EGAT/DC Portfolio Management (PM) team along with any additional information relevant to this particular guarantee.
- EGAT/DC PM team reviews claim for compliance and prepares paperwork for claim approval. Any necessary correspondence with guaranteed party will be cleared by the respective the Mission Officer responsible for the DCA activity and the EGAT/DC Relationship Manager.
- EGAT/DC PM team arranges for clearances by Mission Officer, Relationship Manager prior to submitting to EGAT/DC Director for approval.
- Once approved, EGAT/DC PM team commits and obligates funds from the appropriate DCA Financing Account via Phoenix.[8]
- Upon obligation of the claim amount to be paid, the PM team then notifies FM/LM to instruct the Mission Controller to pay the claim.
- The Mission Controller then makes the claim payment, and obtains reimbursement through FM/LM via the Intra-governmental Payment and Collection (IPAC) system.
- EGAT/DC PM team follows up with email/phone contact to Mission Controller to confirm that claim payment has been made available to the guaranteed party.
- FM/LM notifies the EGAT/DC PM team when evidence of the Controller's transaction has been received. EGAT/DC PM team may then need to adjust the obligation amount due to exchange rate differences.

v. RECOVERIES

The EGAT/DC PM team (with potential field support from the Mission Officer responsible for the DCA activity in case of late responses) will send out annual letters by the first week of June of each year to all FIs that have received a claim payment from USAID.
The letter, signed by the EGAT/DC Director or EGAT/DC PD Relationship Managers, will request that the FI submit a Schedule of Net Recoveries [see template below] by June 30 that

[8] When a DCA guarantee is initially established, the subsidy funds are transferred to the DCA Program Account. As the guarantee is utilized, the subsidy is disbursed proportionally to the DCA Financing Account, where fee payments from guarantee parties are also applied. The combination of subsidy and fees for guarantees obligated within the same fiscal year is the source of funds for claim payments to guaranteed parties.

identifies all claim payments made to a FI and requests updated data and certification on recoveries received by the FI on these defaulted loans.

vi. MISSION SITE VISITS AND EGAT/DC BIENNIAL REVIEWS

Based on OMB Circular A-129, Mission Officer(s) responsible for a DCA activity are required to conduct and report on site visits to the guaranteed party, while the EGAT/DC PM team must conduct biennial reviews of the guarantee. Structures and guidelines for these visits and reviews are provided in the following two tables. Due to the similar nature of the reports described below, the EGAT/DC PM team will coordinate its biennial review with appropriate Mission staff.

Mission Site Visit	
Frequency:	Annually from date agreement is signed, particularly for guarantees with substantial loan volume, signs of deterioration in guaranteed loan(s), high default rates.
Responsible Entity:	Mission Officer responsible for the DCA activity or designee
Responsibilities:	Meet with partner Financial Institution management, establish status of project and determine compliance and performance issues.
Report Outline:	**Preparation**: Summary of telephone/email communication with PM team prior to site visit to understand unresolved monitoring and compliance issues and to review the most current utilization data. **Unresolved Issues**: Discussion of issues from Section I with FI and clarification of how issues are to be resolved. **Country Status**: Update on any country-wide issues that the FI believes is affecting its loan portfolio and/or DCA utilization – economic changes, exchange rate fluctuations, legal/political changes. **Bank Status**: Update on current situation with the financial institution being guaranteed – e.g., personnel, policy or strategy changes, bank performance, merger & acquisition activities. **Borrower Site-Visit**: If possible, request at least one visit to a borrower that received a DCA-guaranteed loan. Summary of visit should include details of: the loan amount, purpose of the loan, loan term, justification for using the DCA guarantee, how it was repaid, and the resulting benefits for the borrower. **USAID Support**: Discussion with FI if USAID can provide any further guidance or assistance in order to promote utilization of and proper reporting on the guarantee. **Conclusion**: Summary of follow-up action items
Delivery of report:	Mission Officer will send completed report via email to EGAT/DC PM team within 30 days of the anniversary of guarantee and EGAT/DC PM team will review the report and ensure that it is appropriately filed. In lieu of this report, the Mission Officer will send EGAT/DC an email to justify that the visit was not necessary. This email will also be filed accordingly.

EGAT/DC Biennial Review	
Minimal Frequency:	Biennially (once every two years) from date agreement is signed or coordinated with a country visit for other purposes
Responsible Entity:	EGAT/DC PM team (with support from Relationship Manager) or designee. If a Mission or its contractor prefers to be responsible for the biennial review, EGAT/DC PM team will review and provide feedback on the biennial report as outlined below.
Responsibilities:	To produce the following report at a minimum of once every two years for a DCA guarantee.
Report Outline: Note: Since the Biennial Report is similar to the Mission On-site Visit Report, EGAT/DC will coordinate its Biennial Review with the Mission to ensure that the FI is not overburdened with similar questions from two different USAID entities.	**Pre-Review Information Gathering**: Review of files to ensure files are current. Analyze recent reporting, fee and claim information to identify any issues that require follow-up with the FI. Data to be summarized and analyzed are: utilization ratios, fees billed and paid, claims net of recoveries as a percent of subsidy + fees, and reporting timeliness. **Unresolved Issues**: Discussion of issues from Section I with FI and clarification of how issues are to be resolved. Also, reminder to FI that have received claim payments of requirement to share recoveries. **Country Status**: Update on any country-wide issues that the FI believes is affecting its loan portfolio and/or DCA utilization – economic changes, exchange rate fluctuations, legal/political changes. **Bank Status**: Update on current situation with the financial institution being guaranteed – e.g., personnel, policy or strategy changes, bank performance, merger & acquisition activities. **Borrower Monitoring**: {if on-site} request to see credit files at the FI on a random selection of at least two borrowers. If possible, request at least one visit to a borrower that received a DCA-guaranteed loan. Summary of visit should include details of: the loan amount, purpose of the loan, the loan term, justification for using the DCA guarantee, how it was repaid, and the resulting benefits for the borrower. **EGAT/DC Support**: Discussion with FI and Mission if EGAT/DC can provide any further guidance or assistance in order to promote utilization of and proper reporting on the guarantee. Conclusion: Summary of follow-up action items
Delivery of report:	EGAT/DC PM team will review this report and ensure that it is appropriately filed. If this report is part of trip report conducted by an EGAT/DC staff member, it will be copied and placed in the appropriate DCA file.

vii. AUDITS

When a guaranteed party submits a claim for payment, the EGAT/DC PM team will monitor the level of claims against the following three criteria:

NOMINAL CHECK	Do cumulative paid and pending claims exceed the equivalent of US$ 20,000?
PORTFOLIO CHECK	Do cumulative paid and pending claims (converted to total loan values) exceed 10% of Cumulative Utilization?
SUBSIDY CHECK	Are cumulative paid and pending claims as a percent of “subsidy plus fees received” above 50%?

Although this three-tiered criteria checklist is primarily applicable to LPGs, which may receive a series of claim payment requests from the guaranteed party, the same guidelines should be utilized for other forms of DCA guarantees. Data related to these three criteria will be included in the summary page provided in the claim package developed by the EGAT/DC PM team. If at least two out of the three criteria result in positive answers, the EGAT/DC PM team will convene to discuss the possibility of an internal review of the guaranteed party's TRs and QLSs. The PM team will then coordinate next steps with the respective Relationship Manager from the EGAT/DC PD team. The Mission will be contacted as necessary, and additional documentation may be requested from the guaranteed party. The PM team, with guidance from the PD team and the Mission, may request a site visit to inspect the credit files of the guaranteed party.

In the event irregularities are found during the EGAT/DC PM team desk or on-site review, an audit should be conducted by an experienced, independent auditor. The EGAT/DC Risk Management (RM) team will coordinate the planning and review of this auditor's performance. The RM team will also conduct this audit with appropriate Mission guidance. Results of this audit will be disseminated between the PM team and the RM team as well as the Relationship Manager to decide on next steps with this DCA guarantee.

The guaranteed party will be required to repay any amounts deemed to have been paid based on disallowed transactions (e.g., unqualified borrowers). If the guaranteed party is judged to have committed fraud, provided erroneous information, or is perceived as unable to carry out the activities and responsibilities of the guarantee, the USAID Office of General Counsel may advise to terminate the agreement following consultations with the Mission and relevant EGAT/DC staff.

viii. BUDGET

- One (1) US Direct Hire Officer responsible for the DCA activity monitoring implementation of the DCA agreement: 3% of time, $138,000 annually for each year during which loans may be placed under coverage. This is based on an annual salary of $93,000 and a benefits package of $45,000.
- One (1) FSN Project Management Specialist: 6% of time, $44,477 per year for each year during which loans may be placed under coverage. This is based on an annual salary $42,877, and benefits of $1,600.
- One (1) FSN in the Financial Management Office: 3% of time, $36,017 per year for each year during which loans may be placed under coverage. This is based on an annual salary $36,017 and benefits of $1,600.
- Travel costs to monitor the program overall and conduct random audits of DCA loans, 5 site visits per year, all trips out of (Mission location), $3,000 for each year during which loans may be placed under coverage.

Total Annual Cost for Mission: $10,890 per year estimate for 7 years (does not include EGAT/DC travel costs).

USAID/W EGAT/DC travel to Romania: $5,000 per trip, 1 trip for every two years is $2,500 per year. Estimated staff time costs for EGAT/DC to monitor this DCA guarantee are:

- EGAT/DC PD and PM team: 7 days per year, $3,500 annually for each year during which loans may be placed under coverage. This is based on an average salary of EGAT/DC personnel of $93,600 and a benefits package of $37,500.
- EGAT/DC PM monitoring contractors: $2,000 annually based on an ongoing contract.

ix. ACCOUNTING CODES

Mission Controllers should utilize the following accounting numbering structure to assist in clearly tracking initial subsidies, modifications, reports, claims and fees:
XXX-DCA-XX-XX-XXX-XXX. Properly including this code along with the name of the guaranteed party on all relevant documents, such as the original obligation, QLS reports and claim payments will ensure that there is a clear audit trail for accounting purposes. Samples can be provided by the PM team if further clarification is required.
This Loan number identification should be structured as follows:

XXX-DCA-xx-xx-xxx-xxx	3-digit country code
xxx-**DCA**-xx-xx-xxx-xxx	3-digit-loan type (DCA)
xxx-DCA-**XX**-xx-xxx-xxx	2-digit for fiscal year
xxx-DCA-xx-**XX**-xxx-xxx	2-digit : S1= Initial Subsidy, M1 = 1st Modification, M2, etc.
xxx-DCA-xx-xx-**XXX**-xxx	2/3-digit type of Guarantee: LG=Loan Guar, LPG=Loan Portable Guarantee, PG=Portable Guar, BG=Bond Guarantee
xxx-DCA-xx-xx-xxx-**XXX**	3-digit loan number = a unique guarantee identifier that is the sequential number of DCA guarantees in a particular country, i.e. 001 for the first guarantee in a country, 002 for the second, etc.
xxx-DCA-xx-xx-xxx-xxx-**XX**	2-digits (used only when obligating funds to clearly identify claims paid)

ACRONYMS

ADQ	Annual Data Questionnaire
CMS	Credit Management System
EGAT/DC	USAID Office of Development Credit
PD	Project Development team at EGAT/DC
PM	Portfolio Management team at EGAT/DC
QLS	Qualifying Loan Schedule
RM	Risk Management team at EGAT/DC
TR	Transaction Report